

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]: TL-N-4918-01
[REDACTED]

date:

to: [REDACTED], Team Manager
Attn: [REDACTED]

from: [REDACTED]
Associate Area Counsel
(Large and Mid-Size Business)

subject: [REDACTED]
Potential Field Service Advice

While preparing this matter as a request for Field Service Advice, we concluded that it is not ready for consideration by National Office. Below, we have set forth the facts as completely as we can, and the positions of the Revenue Agent and the taxpayer interpreting those facts. Following those sections, we set forth what we believe must be done before resolution of the issue can be accomplished.

Preliminary Statement:

Last year, [REDACTED] filed for protection under Chapter 11 of the Bankruptcy Code. The Service timely filed a Proof of Claim earlier this year. The debtor has not yet filed an objection to the Service's Proof of Claim but has provided the Service with a Protest of the various issues raised by the Revenue Agent's Report (RAR) which supported the Service's Proof of Claim. One of the issues raised by the RAR involved an adjustment proposed to increase the capital gain associated with the sale of one of [REDACTED]'s lines of business. The sale was accomplished by forming a limited liability corporation (LLC), capitalizing it with the assets of the line of business, and selling a [REDACTED]% interest in the LLC to an unrelated party. Generally, the issue addressed is the determination of the proper capital gain to be recognized upon the sale of a [REDACTED]% interest in the LLC.

Issue:

Whether, based upon the facts presented, the amounts delineated as "purchase price" and "Closing distribution" should be combined as the sales price of the interest sold.

Facts:

In [REDACTED], [REDACTED] decided to divest itself of at least a portion of its [REDACTED] and [REDACTED] materials business. [REDACTED] formed [REDACTED] or the "Joint Venture"), as the mechanism for the disposition. (The taxpayer has failed to provide documentation establishing the date of incorporation of [REDACTED].) Upon [REDACTED]'s formation, [REDACTED] contributed [REDACTED] manufacturing plants and certain proprietary technology to [REDACTED] in exchange for a [REDACTED] percent ownership interest. The terms of the asset transfer are contained in the Asset Contribution Agreement, dated [REDACTED], as amended by the Restated Asset Contribution Agreement, dated [REDACTED].

During [REDACTED], [REDACTED] also formed [REDACTED]. (As was the case with [REDACTED], the taxpayer has failed to provide documentation establishing the date of incorporation of [REDACTED].) [REDACTED] transferred a [REDACTED] percent interest in [REDACTED] to [REDACTED] in exchange for [REDACTED] shares of [REDACTED] no par common stock.

By [REDACTED], [REDACTED] had sought, and had successfully negotiated, the divestiture of a portion of its [REDACTED] business. The chosen divestiture was accomplished through a sale of a [REDACTED] % interest in [REDACTED] to [REDACTED], a domestic subsidiary of [REDACTED], a French Corporation. According to the [REDACTED] Board of Directors Minutes dated [REDACTED], [REDACTED] had agreed to the sale of a [REDACTED] % interest in [REDACTED]. The Board of Directors noted that upon the divestiture, [REDACTED] would receive a total of \$[REDACTED] in cash at closing. As stated in those Minutes:

[REDACTED] will realize the highest enterprise value of all bidders by forming the joint venture with [REDACTED], including \$[REDACTED] in cash at closing, assumption by the joint venture of \$[REDACTED] of [REDACTED] liabilities and valuation of the [REDACTED] % equity holding in the joint venture at \$[REDACTED] for a total enterprise value of \$[REDACTED].

Those same corporate Minutes contain a number of binding resolutions by the Board of Directors, including the following:

RESOLVED, that [REDACTED] be and it hereby is, authorized to sell to [REDACTED], a Delaware corporation and a wholly owned subsidiary of [REDACTED], a [REDACTED] % membership interest in

[REDACTED] for total cash proceeds of \$ [REDACTED] and such sale be, and it hereby is, ratified and approved in all respects; (emphasis added)

The terms and conditions of [REDACTED]'s sale of the [REDACTED] % interest in [REDACTED] were set forth in a document styled "LLC INTEREST SALE AND PURCHASE AGREEMENT" (the "Sales Agreement"), dated "as of [REDACTED]". According to section 1.2 of the Sales Agreement, the aggregate purchase price of the sale was only \$ [REDACTED], rather than the \$ [REDACTED] reflected in the Minutes of the [REDACTED] Board of Directors. However, section 4.38 of the Sales Agreement required that:

Immediately upon the Closing, the parties shall cause the Company [REDACTED] to and the Company shall make a cash distribution in the aggregate amount of [REDACTED] Dollars (\$ [REDACTED]) to its members, pro rata in accordance with their respective ownership interest ...

The [REDACTED] % share of [REDACTED] retained by [REDACTED] by virtue of its ownership interest in [REDACTED] entitled it to a portion of that "distribution" amounting to \$ [REDACTED]. That "distribution", when coupled with the "purchase price" of \$ [REDACTED] would have provided [REDACTED] with \$ [REDACTED] an amount conspicuously similar to the sales price of \$ [REDACTED] reflected in the Minutes of the Board of Directors of [REDACTED].

The LLC INTEREST SALE AND PURCHASE AGREEMENT was amended "as of [REDACTED]". Among the changes to the Sales Agreement, was the \$ [REDACTED] reduction of the aggregate purchase price from \$ [REDACTED] to \$ [REDACTED]. In addition, in section 4.36 of the amendment, the Buyer agreed that immediately prior to the closing ([REDACTED] all cash and cash equivalents, including, without limitation, bank deposits, investments in so called money market funds, commercial paper funds, Certificate of Deposits, Treasury bills and accrued interest thereon, of the company will be withdrawn or otherwise transferred from the company to Seller and or [REDACTED]. The first modification, in section 4.38, entitled "Post Closing Distribution", still required that immediately upon the closing, the parties shall cause the company to and the Company shall make a cash distribution in the aggregate amount of \$ [REDACTED] to its members, pro rata in accordance with their then respective ownership interests in the Company, and that the Buyer shall have caused the Company to obtain any and all financing necessary to fund such cash distribution.

A second modification of the LLC INTEREST SALE AND PURCHASE AGREEMENT was later executed which increased the stated purchase price to \$[REDACTED]. The second modification also included the Buyer's obligation to make an incentive compensation payment of \$[REDACTED] to the transferred employees. The Seller also received back in the settlement certain inventory as identified on Schedule A of the second amendment to the agreement. Finally, the second modification of the Sales Agreement altered section 4.38 (the Closing "distribution") to decrease the distribution by \$[REDACTED], from \$[REDACTED] to \$[REDACTED], percent of that distribution amounts to \$[REDACTED].

On [REDACTED], [REDACTED] completed the sale of its [REDACTED] percent interest in [REDACTED] to [REDACTED], the [REDACTED] subsidiary. Simultaneous with the sale, the [REDACTED] name was changed to [REDACTED], and the purchaser, [REDACTED] was renamed [REDACTED]. In order to make the purchase, [REDACTED] borrowed \$[REDACTED] from its parent, and secured a one-day loan of \$[REDACTED] from [REDACTED] an unrelated bank. From these loans, which totaled \$[REDACTED] [REDACTED] paid [REDACTED] \$[REDACTED] at the Closing, an amount denominated as the "purchase price" of the [REDACTED] percent interest sold. As required, [REDACTED] caused [REDACTED] to borrow \$[REDACTED] (also from [REDACTED], effective the day of the Closing, and thus, the total amount borrowed reached \$[REDACTED]. According to SEC filings, in order for [REDACTED] to obtain the loan from [REDACTED], [REDACTED] guaranteed the repayment of the \$[REDACTED].

Of the \$[REDACTED] borrowed, [REDACTED] distributed \$[REDACTED] at Closing, \$[REDACTED] to [REDACTED], representing its [REDACTED] percent interest in the "Closing distribution", and \$[REDACTED] to [REDACTED] as its [REDACTED] percent interest. [REDACTED] used its distribution to repay its initial \$[REDACTED] borrowing from [REDACTED]. Thus, at the end of the Closing, [REDACTED] owed its parent \$[REDACTED], and [REDACTED] owed \$[REDACTED] to [REDACTED].

At issue is whether the \$[REDACTED] received as a "Closing distribution" should be considered part of the sales price received by [REDACTED] for the [REDACTED] percent interest in [REDACTED] sold.

Revenue Agent's Position:

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits which were not intended by Congress, by means of transactions

that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1964); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959), cert. denied, 364 U.S. 908 (1960); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F.3d 231 (3d Cir.), cert. denied, 526 U.S. 1017 (1998).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247.

The contrived configuration used by the taxpayer here must be viewed as a disguised sale of a partnership interest. The Board of Directors of [REDACTED] approved the sale of the [REDACTED] partnership interest in [REDACTED] for \$[REDACTED]. Bifurcating the sales price into two parts, one labeled the "purchase price" and the other a "distribution" does nothing to alter the substance of the transaction. The \$[REDACTED] "Closing distribution" is nothing but an attempt to disguise part of the agreed upon purchase price. The "separate" distribution to [REDACTED] immediately upon closing lacked economic substance and should be disregarded as a separate transaction for Federal income tax purposes. The true economic substance of the cash distribution, which occurred immediately upon closing, is that it is part of the sales proceeds which were due to [REDACTED] from the sale of the [REDACTED] percent interest in [REDACTED].

The transparent recasting of the agreed purchase price into two parts cannot hide that the substance of the configuration was a sale of the [REDACTED] % interest in [REDACTED]. The only purpose of the "separate" \$ [REDACTED] cash distribution was an attempt to allow [REDACTED] to defer the tax they would have to realize upon receiving the "distribution" as its true form, additional sale proceeds. The \$ [REDACTED] cash distribution and the \$ [REDACTED] of sale proceeds were received on the same day and were both deposited into an [REDACTED] bank account.

The separate, yet simultaneous payment of the "Closing distribution" was an attempt to defer the tax of [REDACTED]. See Merryman, 873 F.2d 879 (5th Cir. 1989) (court disregarded sale-leaseback to partnership with certain partners who were unrelated to the transferor); Shaffer Terminals, Inc., 16 T.C. 356 (1951), aff'd, 194 F.2d 539 (9th Cir. 1952) (sale-leaseback to commonly controlled partnership was disregarded); Unger v. Campbell, 61-1 USTC ¶9163 (N.D. Texas 1960) (sale-leaseback to taxpayer's mother was disregarded); Valley Camp Coal Co. v. Commissioner, T.C. Memo 1967-225, aff'd, 405 F.2d 1208 (6th Cir. 1969) (in substance the taxpayer was the purchaser of the property, the corporation the taxpayer formed was merely a conduit through which the taxpayer paid the purchase price).

A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalities, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

In this case, [REDACTED] (or [REDACTED]) was merely a conduit through which the buyer made the additional \$ [REDACTED] payment of the true sales price. The Sales Agreement made the buyer ultimately responsible for obtaining the financing for the cash distribution. Whether the buyer paid the \$ [REDACTED] directly to [REDACTED] or indirectly, through [REDACTED] to [REDACTED], the payment represented part of the sales price.

The two steps utilized by the instant taxpayer must be collapsed into their true essence, the payment of the sales proceeds resulting from the sale by [REDACTED] of its [REDACTED] % interest in [REDACTED]. In Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir 1970), cert. denied, 401 U.S. 939 (1970), a somewhat similar disguised transaction was addressed. There, a taxpayer attempted, for tax purposes, to bifurcate a single transfer into two steps, a sale and a dividend. The Court concluded that the dividend and sale were but one transaction and that any "dividend" paid was merely an

additional amount of the purchase price, albeit, paid through a conduit. Waterman, 430 F.2d at 192. The application of the idea of collapsing several steps into one is provided by Kanawha Gas & Utilities v. Commissioner, 214 F.2d 685 (5th Cir. 1954), which held:

In determining the incidence of taxation, we must look through the form and search out the substance of the transaction. * * * This basic concept of tax law is particularly pertinent to cases involving a series of transactions designed and executed as parts of a unitary plan to achieve an intended result. Such plans will be viewed as a whole regardless of whether the effect of doing so is imposition of or relief from taxation. The series of closely related steps in such a plan are merely means by which to carry out the plan and will not separate.

Kanawha, 214 F.2d at 691.

Obviously, the form of the transaction is relatively unimportant. The true substance of the transaction must be followed. Functionally, the two steps advocated by the taxpayer are simply parts of a single plan, a plan contemporaneously captured in the Board of Directors' minutes of [REDACTED] as the sale of the [REDACTED] % interest in [REDACTED] for \$[REDACTED]. The payment of the \$[REDACTED] "Closing distribution" would never have existed independently from the sale of the [REDACTED] % interest, and it cannot be viewed as a separate event.

Taxpayer's Position:¹

Initially, the agent takes the position that the distribution of loan proceeds to [REDACTED] is actually additional sale proceeds. The underlying premise of this assertion is that there is no valid business motivation or economic purpose for the distribution besides tax savings. [REDACTED] agrees with the agent's statement that "in determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined".

The issue here is the business motivation. To finance the purchase, [REDACTED] (the parent of [REDACTED]) loaned \$[REDACTED] of [REDACTED]. [REDACTED] also arranged for a one-day

¹ This section is taken verbatim from the taxpayer's protest.

loan ("Daylight Loan") from [REDACTED] in the amount of \$[REDACTED]. These transactions provided [REDACTED] with the funds to purchase [REDACTED]'s [REDACTED]% interest in [REDACTED]. [REDACTED] then borrowed \$[REDACTED] from [REDACTED] under a senior credit facility and a senior subordinated credit facility. From these funds, [REDACTED] then made a \$[REDACTED] distribution; [REDACTED]% (\$[REDACTED]) to [REDACTED] and [REDACTED]% (\$[REDACTED]) to [REDACTED]. [REDACTED] then used its share of the distribution to repay the Daylight Loan to [REDACTED]. The business purpose of the distribution is apparent; it allowed [REDACTED] to acquire [REDACTED]% of [REDACTED] for \$[REDACTED] in cash. In fact, on [REDACTED], [REDACTED] issues a press release announcing that it had acquired [REDACTED]% of [REDACTED] for "\$[REDACTED] in cash". This is a prototypical example of a leveraged buy-out with the acquirer using the assets of the acquisition as security to finance the transaction. To maintain its [REDACTED]% ownership interest in [REDACTED], [REDACTED] had to receive [REDACTED]% of the distribution.

The clear substance of the transaction is to minimize the out-of-pocket cash cost of the acquisition to [REDACTED]. The reason for the distribution is clearly identified in a Form S-4 filed by [REDACTED] (a brother-sister corporation of [REDACTED] sharing a common parent, [REDACTED]) with the Securities & Exchange Commission (SEC) on [REDACTED]. As stated in the Form S-4: "immediately after completion of the purchase, [REDACTED] paid [REDACTED] a \$[REDACTED] dividend and [REDACTED] used this money to repay the \$[REDACTED] intra-day loan and the \$[REDACTED] in other borrowing." As specifically identified in this SEC filing, the distribution was made to allow [REDACTED] to repay the [REDACTED] intra-day loan, thereby minimizing the out-of-pocket cost of the [REDACTED] acquisition by [REDACTED] to \$[REDACTED].

Reg. Sec. 1.707-5(b) (Treatment of debt-financed transfers of consideration by partnerships) states, if a partner transfers property to a partnership that a debt-financed transfer of money to partners within 90 days of incurring the liability is treated as sales proceeds "only to the extent the amount of money transferred exceeds that partner's allocable share of the partnership liability". [REDACTED] retained a [REDACTED]% interest in the assets, which secured the loan. Therefore, it has a [REDACTED]% share in the liabilities, which are secured by the assets. As the distribution to [REDACTED] did not exceed its [REDACTED]% share of the liability, no gain is recognized by [REDACTED] on the distribution.

Also, the agent supports his position with statements, which are inaccurate.

He states the "Board of Directors of [REDACTED] approved the sale of the [REDACTED]% partnership interest for \$[REDACTED]". He takes the position that there were "later modifications" to

bifurcate the agreed upon sales price into two parts", sales proceeds and the distribution. The minutes (meeting of [REDACTED]) actually say that [REDACTED] "will realize \$[REDACTED] cash at closing". The minutes cited do not approve the sale for \$[REDACTED]. The sales agreement, which addresses both the sales price and the distribution, was also entered into on [REDACTED]. The implication that there was some later modification to "disguise" the nature of the transaction is unfounded and has no basis in fact.

He states that "the only purpose of the cash distribution was an attempt to allow [REDACTED] to defer the tax". As explained above, there was a clear business motivation for [REDACTED] to compel [REDACTED] to make the distribution.

His final argument is that the "two steps" (sales proceeds and distribution) have to be "collapsed" into one to reflect the true essence of the transaction. This is incorrect, as there are two distinct transactions. The first (sales proceeds) is the sale of [REDACTED]'s [REDACTED]% interest in [REDACTED]. This is a distinct economic transaction entered into by two unrelated parties, [REDACTED] and [REDACTED]. The second is the distribution by [REDACTED] to its partners, [REDACTED] and [REDACTED]. This is an entirely separate transaction entered determined by [REDACTED] as part of its overall strategy for financing its acquisition of [REDACTED]% of [REDACTED]. The purchase and [REDACTED]'s financing of the purchase are two unique transactions and there is no basis for them to be "collapsed" into one as asserted by the agent.

To support his position that the \$[REDACTED] distribution should be disregarded and, instead, should be treated as additional sales proceeds, the agent cites several cases:

Merryman, 873 F2d 879, 55 TCM 191

Unger, 61-1 USTC ¶ 9228

Valley Camp Coal Company, 69-1 USTC ¶ 9172

Waterman Steamship Corporation, 70-2 USTC ¶ 9514

Shaffer Terminals, Inc., 16 TC 356

The common thread running through all of these cases is the general concept of "substance over form" (to be respected for tax purposes a transaction must have economic substance). As explained above, there was a clear and indisputable business purpose for the distribution. Without the distribution, [REDACTED] and [REDACTED] would have been unable to finance the acquisition of [REDACTED]. Therefore, since the transaction (distribution by [REDACTED] to [REDACTED] and [REDACTED]) does have economic substance and a legitimate business purpose, the cases cited by the agent are not relevant to the issue.

Conclusion:

Having examined both the revenue agent's and the taxpayer's positions, I believe both positions ignored a fundamental fact. In order to resolve this issue, I believe we must know what the appraised value of [REDACTED] (or [REDACTED] was at the time of the sale of a [REDACTED]% interest. Under the revenue agent's pricing theory, a [REDACTED]% interest in [REDACTED] was sold by [REDACTED] for roughly \$[REDACTED]. That translates into an enterprise value of a little over \$[REDACTED] (\$[REDACTED]). The taxpayer, on the other hand, suggests that it was paid \$[REDACTED] for the [REDACTED]% interest, suggesting a total enterprise value of \$[REDACTED] (\$[REDACTED]).

The fundamental issue apparently ignored by both positions is the determination of what the value of [REDACTED] really was. If [REDACTED] was worth \$[REDACTED] as the agent's theory suggests, then regardless of the labels put on the steps of the transaction, a [REDACTED]% interest would not be sold at arm's length to an unrelated party for only \$[REDACTED]. It just wouldn't happen. Likewise, if [REDACTED] was worth only \$[REDACTED] as the taxpayer suggests, then no matter what arguments we want to raise, an unrelated third party would not spend \$[REDACTED] to purchase a [REDACTED]% interest in an asset worth only \$[REDACTED].

It seems to us that once the fair market value of [REDACTED] is known, the substance of the transaction should become easily visible. Once the value of [REDACTED] is known, let's revisit this issue, if necessary.

[REDACTED]
Associate Area Counsel

By: _____

[REDACTED]
Special Litigation
Assistant